MARCH 2011

Public employee pensions remained in the spotlight in March. While political battles over the benefits received by state and local workers continued in Wisconsin, Ohio and elsewhere, several members of Congress took up the issue. A House of Representatives subcommittee held its second hearing of the year on public pensions, a senator introduced legislation that would close the federal government's defined benefit pension plan, and a senior Republican lawmaker took to the floor of the Senate to denounce public pensions, saying that states and localities that have them are "playing irresponsibly with taxpayer money."

ISSUES AND EVENTS

GOP Senator Seeks to End Federal Employee Defined Benefit Plan

The federal government would close its defined benefit pension plan to new hires if a bill proposed by a Republican senator becomes law.

The "Public-Private Employee Retirement Act of 2011" (S. 644) from Sen. Richard Burr, R-N.C., would end the defined benefit pension portion of the Federal Employee Retirement System (FERS) for new federal government hires starting in 2013. Current employees – and those hired through 2012 – would not be affected. The government's Thrift Savings Plan – which offers federal employees 401(k)-like investment accounts with a limited employer match – would be unchanged.

"Right now, federal government workers receive far more generous retirement benefits than private sector employees," Burr said. "The cost to taxpayers of these benefits is unsustainable and we simply cannot afford it. We cannot ask taxpayers to continue to foot the bill for public employee benefits that are far more generous than their own."

The bill would apply to members of Congress.

"The congressional pension plan currently in place only serves to foster political careerism and should have been frozen years ago," Sen. Tom Coburn, R-Okla., a co-sponsor of the bill, said. "When American families across the country are being asked to sacrifice in order to meet their basic needs, federal employees and members of Congress should not be the exception. Defined benefit pension plans are going belly-up across the nation because politicians and employers continue to make promises they cannot keep. … The only responsible thing to do is stop making irresponsible commitments and forcing future generations to pick up the tab."

Burr said that the FERS pension is underfunded by almost $1 billion, but John Gage, national president of the American Federation of Government Employees, said that "Senator Burr is wrong on the facts and wrong on morals."

"Eliminating pensions for future employees would do absolutely nothing for the fictional unfunded liabilities that the fact-challenged senator imagines he is resolving," Gage said. "Worse, Senator Burr's bill is a mean-spirited attempt to deprive future employees of any hope of a dignified retirement after they have spent a lifetime in public service."

Similarly, Joseph Beaudoin, president of the National Active and Retired Federal Employees Association, said that "the federal pension program is fully funded, actuarially sound and paid for largely by federal employees themselves."

"Changes to policies that affect federal employees threaten the future of the vital services they perform," Beaudoin said. "Without employment packages that are competitive in the professional marketplace, our government will struggle to attract the best workers to protect us. Considering the importance of the federal meat inspectors in Kansas who ensure our food is safe or the U.S. nuclear regulators who now are working in Japan to avert a nuclear catastrophe, we can ill afford to shy away from support for our nation's federal workers."

In February, Burr introduced the "Public Employee Pension Transparency Act" (S. 237), which would require state and local pension funds to disclose their liabilities as calculated using a "risk-free" rate of return – essentially, what would be expected from Treasury bonds – and would prohibit federal bailouts of public pensions. The measure is sponsored in the House of Representatives by Rep. Devin Nunes, R-Calif.

House Panel Again Examines Public Pensions and State Debt

A congressional panel on March 15 held its second hearing of the year on the effect that public pensions have on state finances, but, as before, no consensus emerged about the magnitude of the impact or the proper response.

While Rep. Patrick McHenry, R-N.C., the chairman of the House Oversight and Government Reform Committee's TARP, Financial Services and Bailouts of Public and Private Programs Subcommittee, called state and local pension underfunding an "immediate crisis" – citing a study by Northwestern University Professor Joshua Rauh that, nationwide, state and local retirement plans have a combined shortfall of about $3 trillion – a projection about four times greater than estimates from within the public pension community – opinions among witnesses at the hearing were split.

Robert Kurtter, managing director for U.S. Public Finance for Moody's Investors Service, said that public pension (and health care) liabilities are just one of four factors that are having a negative impact on state credit ratings, the others being the economy, lingering fiscal pressures and reduced revenues caused by high unemployment. He said, though, that despite "unprecedented financial strain on the U.S. public finance sector," the "fundamentals of the state sector remain strong" in terms of credit risk and it is "highly unlikely" that any state will default on its bonds within the next 18 months.

Robin Prunty, managing director for ratings services at Standard & Poor's Financial Services, said that she also does not expect states or municipalities to default on their bond obligations. While "pensions and other post-employment benefit obligations represent material long-term risks to governments," she did not characterize the situation as a crisis.

"In general, we believe worst-case scenarios regarding pensions will likely occur only if governments are unable or unwilling to use their powers of adjustment," she said.

Both Kurtter and Prunty discussed the possibility of the Governmental Accounting Standards Board requiring more uniform financial disclosures about pension funding, with Kurtter saying it would be helpful, but Prunty suggesting that the differences between plans could make it difficult. (On a separate, but related issue, GASB in March released a report on the timeliness of financial reporting by state and local governments that concluded that there is a "noticeable gap between when financial information is most useful to the users of [annual financial reports] and when governments provide that information.")

Dean Baker of the left-leaning Center for Economic and Policy Research said that states' fiscal problems have resulted from a recession caused by inadequate financial regulation, and that their debt will decrease as the economy improves and the stock market recovers. Baker also challenged the argument by many critics of public pensions that states and localities should estimate liabilities based on a "risk-free" rate of return – as would be provided by U.S. Treasury bonds – rather than the significantly higher historical rate, saying that using the risk-free rate "would likely lead to the elimination of traditional pensions and impose unnecessary costs on taxpayers."

"State and local governments are fundamentally different from individual investors," Baker said. "Individual investors must be concerned that the market could be depressed at the time when they retire or have other reason to need their savings. For that reason, they do substantially discount the risk associated with the volatility of the stock market. The logic of using expected values, rather than the risk-free rate, stems from the fact that state and local governments are better able to bear risk than individual investors. If the market experiences a downturn, as is now the case, state and local pension funds can easily cover their pension obligations from the current funding flows combined with the sale of non-equity assets. It would take a truly extraordinary set of events – one much worse than the downturn that we are currently experiencing – to force pension funds to liquidate large amounts of their equity investments in a down market."

Oversight and Government Reform Committee Chairman Darrell Issa, R-Calif., asked if the rates of return used by CalPERS and the California State Teachers' Retirement

System are reasonable, and Baker said that, based on current price-to-earnings ratios, they are.

Andrew Biggs, resident scholar at the conservative American Enterprise Institute, though, supported using the risk-free rate, saying, "Private pension accounting, economic theory, and the practice of financial markets dictate that the appropriate discount rate applied to a given liability is based upon the risk characteristics of the liability, not of funds that may be set aside to fund that liability."

"Put simply," Biggs said, "public pension accounting standards encourage state and local governments to promise too much, fund too little and take too much risk with their investments. … The more risk you take, the better funded you look. Indeed, public pensions around the country could erase their reported $500 billion underfunding – on paper at least – by shifting to an all-equity portfolio with an expected return of 10 percent. Such a portfolio shift would do nothing to improve pension funding in reality, but it would violate neither the mathematics nor the underlying logic of current pension accounting standards."

Biggs endorsed legislation from Rep. Devin Nunes, R-Calif., and Sen. Richard Burr, R-N.C., that would require state and local pension funds to disclose liabilities using a risk-free rate and would prohibit federal bailouts of public pensions.

"The sooner policymakers and the public are made aware of true levels of pension and other obligations, the sooner and more effectively we can act to address them," Biggs said. "It would be ironic indeed if, even as we recover from our last self-inflicted financial crisis – caused by lax accounting and aggressive investing in housing – we stumbled into our next, founded in the same basic errors."

Utah state Sen. Dan Liljenquist, a Republican, said that one "upside" to the recession is that "taxpayers throughout the United States are waking up to the massive liabilities incurred by state and local governments," particularly those liabilities related to public employee benefits. He noted that, after market losses in 2008 caused his state's pension funding status to drop from 100 percent to 70 percent, lawmakers closed Utah's public employee defined benefit pension, shifting new hires into defined contribution accounts.

"Those states who choose to tackle pension reform by capping defined benefit systems and migrating towards defined contribution systems will find that taxpayers are with them," Liljenquist said. "Those states who choose not to do so will continue to subject their taxpayers to the whims of an unpredictable market."

GOP Senator Takes Aim at Public Pensions

A senior Republican senator warned in mid-March that, by continuing to provide public employees with defined benefit pensions, state and local governments are "living in the past, playing irresponsibly with taxpayer money, and leaving taxpayers to foot the bill for too many lifetime pension promises."

In a speech on the floor of the Senate on March 17, Sen. Orrin Hatch, ranking Republican on the Senate Finance Committee, noted that, while the private sector has largely abandoned traditional pensions in favor of defined contribution accounts, such as 401(k)s, "governments have been slow – and public employees have been resistant – to transitioning to the types of retirement plans that private sector workers have been living with for years."

"The rest of the world has moved toward 401(k)-style plans, called defined contribution plans," Hatch said. "In these plans, costs are lower and more predictable. And they fit well with an increasingly mobile and dynamic workforce. … Yet governments have kept their unaffordable traditional plans, often because public employee unions use taxpayer-funded union dues to elect state and local politicians, and then ask the same politicians they just elected for costly pension deals at taxpayer expense."

Hatch noted federal lobbying efforts by the American Federation of State, County and Municipal Employees and the AFL-CIO and said that he wanted to "congratulate" Wisconsin Gov. Scott Walker for not "caving under the pressure of union organized protests."

Referencing several studies, including one by Northwestern University Professor Joshua Rauh that has often been cited by critics of public pension plans, Hatch said that, nationwide, public pensions are underfunded by $2.5-3 trillion – numbers that are about four times greater than estimates from within the public pension community – and added that, "A study published last month found that, all by itself, California has a $240 billion public pension shortfall.

"You heard that right," Hatch said. "California alone has a pension debt of one-quarter of a trillion dollars."

Hatch said he plans to "find a way to address the public pension crisis if state and local governments don't step up to the plate."

"I am under no illusions that this will be an easy task," he said. "The problem is both large and complex. There are many potential solutions that must be studied, and some will not be pleasant. Some of my colleagues here in the Senate have a proposal to address the problem, and I will be working with them as well. I do not have all of the answers yet, and I have not yet settled on what I believe are the best solutions. But we are working hard and talking to the experts about the best way to proceed."

Social Security for All New Hires Would Cut Federal Deficits by $96 Billion Over 10 Years: CBO

Requiring all newly-hired public employees to participate in Social Security would increase federal revenues by $23.7 billion over five years and $96 billion over 10 years, according to a new study from the Congressional Budget Office (CBO).

The forecasts, which are included on pages 171-172 of a CBO report on options for reducing the federal deficit, somewhat understate the costs to state and local governments because, when calculating the net effect on federal revenues, the increased Social Security taxes are partially offset by decreased income taxes.

The report stated that the move would "slightly" improve Social Security's long-term finances and would have the additional benefits of improving "fairness," providing "better retirement and disability benefits for many workers" who change jobs, and "facilitating job mobility."

CBO acknowledged, though, that requiring Social Security participation "might place an added burden on some state and local governments, which already face significant budgetary challenges," probably leading them to restructure their employee retirement plans in one of two ways, both of which could create difficulties.

"First, they might exclude newly hired state and local employees from participation – thereby forgoing a possible source of new funding – which would place an additional burden on those governments," the report stated. "Second, they might choose to supplement the Social Security coverage for new employees, but costs to state and local governments would have to increase to provide an equivalently valued benefit package that included Social Security. Total costs would be higher because the cost per dollar of Social Security benefits for state and local government employees would probably exceed the cost per dollar for pensions provided by state and local governments."

CBO suggested that delaying implementation would give states and localities time to make adjustments to their pension plans.

"Nevertheless," the report stated, "costs to the affected state and local governments would probably rise."

Nearly 2/3 of Senators Urge Obama to Support Deficit Reduction

A bipartisan group of 64 senators delivered a letter to President Obama on March 18 that urged him to "support a broad approach" to reducing the federal budget deficit.

The one-page letter, dated March 15, which was drafted by Sens. Michael Bennet, D-Colo., and Mike Johanns, R-Neb., and signed by 32 Democrats and 32 Republicans, referenced the recommendations of the 2010 National Commission on Fiscal Responsibility and Reform. That panel's report outlined a way to reduce federal budget deficits by $3.8 trillion over 10 years through spending cuts, entitlement reforms and an overhaul of the tax code. The plan won the support of 11 of the panel's 18 members – who were evenly divided between Democrats and Republicans – but it needed 14 to trigger an up-or-down vote in Congress.

"While we may not agree with every aspect of the Commission's recommendations, we believe that its work represents an important foundation to achieve meaningful progress on our debt," the letter stated.

The senators noted that a deficit reduction package should include "discretionary spending cuts, entitlement changes and tax reform," though they did not get more specific than that.

"By approaching these negotiations comprehensively, with a strong signal of support from you, we believe that we can achieve consensus on these important fiscal issues," the letter stated.

The Obama administration expressed support for the general goals of the letter but did not pledge any specific action.

"We believe it's a positive development anytime Democrats and Republicans come together to work on one of our nation's toughest challenges," a White House spokesman said, "and we will continue to work with members of Congress from both sides of the aisle to rein in our deficit, grow our economy and win the future."

Sen. Dianne Feinstein, D-Calif., signed the letter, but Sen. Barbara Boxer, D-Calif., did not.

On the same day the letter was delivered, the Congressional Budget Office (CBO) released a report that concluded that federal deficits between 2012 and 2021 will total $9.5 trillion, doubling the total amount of publicly-held debt to $20.8 trillion. The CBO's deficit estimates for the next decade are $2.3 trillion higher than what the administration projected in its fiscal year 2012 budget.

Obama Administration Seeking Quick Review of Health Care Ruling

The Obama administration on March 10 officially declared its intention to appeal a federal judge's ruling that the health care reform law is unconstitutional and to try to put the case on a fast track to the U.S. Supreme Court.

U.S. District Court Judge Roger Vinson in January ruled against the law in a case filed by 26 state attorneys general because of its requirement that every American have health insurance, but he did not order that implementation of the law be stopped. After officials in several states indicated that they would not implement the law because of the ruling, the Obama administration on Feb. 17 asked Vinson to clarify his ruling by asserting that, while the case is being appealed, states must proceed with putting the law's provisions into place. On March 3, Vinson stayed his ruling, pending appeal, but only on the condition that the administration file its notice of appeal within seven days and seek an expedited appellate court review, writing, "The sooner this issue is finally decided by the Supreme Court, the better off the entire nation will be."

The administration, in meeting those conditions, said it is seeking an expedited review of the case by the U.S. Court of Appeals for the 11th Circuit in Atlanta, which will probably hear the case in late summer or early fall. The case could reach the Supreme Court in time for a ruling before the next presidential election.

The states that challenged the law, meanwhile, filed notice on March 10 that they plan to appeal certain "adverse" provisions of Vinson's January ruling.

Several other challenges to the law are pending in other courts.

CalPERS Backs Reappointment of Aguilar to SEC

CalPERS is urging the Obama administration to reappoint Luis Aguilar to the Securities and Exchange Commission (SEC).

Aguilar was appointed to the SEC by President George W. Bush in 2008 to fill the unexpired term of Roel Campos. Aguilar's term expired in 2010, but he continues to serve pending reappointment or replacement. In a March 4 letter to the White House supporting a second term for Aguilar, CalPERS CEO Anne Stausboll wrote that he "has embodied the Commission's mission to be 'the investors' advocate.'"

"Commissioner Aguilar … has been a vocal supporter of providing investors a market-driven mechanism for holding boards of directors accountable," Stausboll wrote. "He understands that the ability of significant, long-term shareowners to nominate candidates for boards is paramount to fundamental corporate governance and we applaud his support for meaningful proxy access."

Stausboll also noted that Aguilar supports diversity in corporate boardrooms and increased disclosures regarding board nominations, and that he "brings to the SEC more private sector experience than any other sitting Commissioner."

"As the SEC continues to move forward with the implementation of critically important provisions of the historic Dodd-Frank Wall Street Reform and Consumer Protection Act, we believe that Commissioner Aguilar's participation is essential to the Commission's ongoing success," she wrote. "He has been an unwavering advocate for investors and has aggressively supported the enforcement of securities laws."

HHS Notes Savings from Early Retiree Program for CalPERS, Others

CalPERS has received the most money of any public sector health benefits provider from a program designed to ease the costs of health care for early retirees, according to a report released on March 2 by the U.S. Department of Health and Human Services (HHS).

The 2010 health care reform law created the Early Retiree Reinsurance Program to provide $5 billion through 2014 to offset employers' spending on health care benefits for retirees between the ages of 55 and 64. Employers can seek reimbursement for 80 percent of the costs between $15,000 and $90,000 for services that would be covered by Medicare for retirees who are 65 and older.

The program had saved employers more than $535 million through the end of 2010, the report stated.

"The Early Retiree Reinsurance Program is helping to control health care costs and protect coverage for early retirees and their families," HHS Secretary Kathleen Sebelius said. "This program is providing critical financial relief to help states, private employers and other organizations preserve access to affordable health coverage for millions of Americans."

As of the end of 2010, state and local government entities represented 47 percent of the more than 5,400 participants approved for the program and had received more than half - $298 million – of the funds disbursed. CalPERS had received the largest amount – $57.8 million – of any public sector organization, and the report noted the pension fund's efforts to pass along those savings to members.

"In anticipation of ERRP reimbursement CalPERS worked with its benefits carriers to mitigate 2011 premium increases by three percent – a savings of up to $200 million," the report stated. "According to CalPERS officials, the ERRP funding will directly benefit 1.1 million public employees, retirees, and their dependents (including 115,000 ERRP eligible early retirees), many of whom have been subject to declining wages due to state furloughs imposed to address budget shortfalls."

Sebelius in December praised CalPERS on the White House blog for the fund's implementation of the early retiree program and other provisions of the reform law.

Drug Price Increases Nearly Doubled Overall Medical Inflation: GAO

The average price of 100 commonly used prescription drugs increased at an annual rate of 6.6 percent from 2006 to 2010, nearly double the medical consumer price index during that time of 3.8 percent, according to a report released in March by the Government Accountability Office (GAO).

The average price of the 55 brand-name drugs in that batch increased 8.3 percent, while the average for the 45 generics grew 2.6 percent.

The report noted that "Some media reports have suggested that prescription drug prices may have increased more during the debate leading up to passage of the Patient Protection and Affordable Care Act (PPACA) in March 2010 compared to other recent years," but the GAO did not find this to be the case. In the year preceding the passage of reform, the 100-drug price average increased 5.9 percent.

Prescription drug spending totaled $250 billion in 2009, with nearly a third of that – $78 billion – being spent by the federal government, the GAO found.

The report was requested by five senior Democratic congressmen, including House Energy and Commerce Committee Ranking Member Henry Waxman of California and House Ways and Means Committee Health Subcommittee Ranking Member Pete Stark of California.

GAO Warns of Conflicts of Interest in 401(k) Advice

Conflicts of interest "hinder participants' retirement security and call into question the integrity of the 401(k) system" and must be addressed, the Government Accountability Office (GAO) concluded in a report released in early March.

The GAO found that it is often unclear "when a service provider is acting in the role of a salesperson rather than a fiduciary adviser." The agency also concluded that plan participants cannot always tell the difference between general education about the investment process – which may include specific products as examples, not recommendations – and formal investment advice.

"If left unchecked, conflicts of interest could lead plan sponsors or participants to select investment options with higher fees or mediocre performance, which, while beneficial to the service provider, could amount to a significant reduction in retirement savings over a worker's career," the agency noted in the report, which was prepared for House Education and the Workforce Committee Ranking Member George Miller, D-Calif.

The GAO also noted the "responsibility and risk borne by workers in 401(k) plans" and the resulting need for them to make good investment decisions, in contrast to participants in traditional defined benefit plans, who do not bear the risk associated with investment choices.

"Several studies have found that, from 1988 to 2006, DC plans underperformed DB plans by 1 percentage point or more, which may be explained by higher fees in 401(k) plans and a lack of diversification in participants' investment allocations," the report stated.

The GAO recommended that the Department of Labor:

- Require that service providers' written disclosures specifying that their guidance should not be interpreted as impartial investment advice be provided to the plan sponsor in a consistent and prominent manner.

- Require that information regarding disclosure of service providers' direct and indirect compensation from plan investments and fiduciary status be provided in a consistent and summary format.

- Revise provisions of the department's guidance on investment education that permit a service provider to highlight certain investment alternatives, such as proprietary funds, which may result in greater revenue to the service provider, in educational materials.

- Require that service providers, when assisting participants with the purchase of investment products offered outside of their plan, disclose any financial interests they have in such products and inform participants as to whether their assistance is subject to ERISA fiduciary standards.

The agency also recommended that the Treasury Department require that service providers, when recommending the purchase of investment products outside of retirement plans, inform participants that fees outside their plans may be higher than fees within their plans.

Labor and Treasury both generally agreed with the GAO's findings and recommendations, according to the report

RELATED NATIONAL AND INDUSTRY NEWS

Report Finds Extensive Retirement Anxiety

Americans are anxious about retirement and want the federal government to do more about it, according to a report released in March by the National Institute on Retirement Security (NIRS).

"Pensions and Retirement Security 2011: A Roadmap for Policymakers," which was released in conjunction with the NIRS annual conference on March 7-8, reported that 84 percent of Americans are worried about being able to achieve a secure retirement, with the same number saying that individuals who have traditional defined benefit pensions are more likely to reach that goal. The report also found that nearly 90 percent think that the nation's retirement system is under stress and in need of reform, and 80 percent believe that federal officials have not made ensuring retirement security a high enough priority.

"This report makes it clear that Americans understand we're on the verge of a retirement breakdown," NIRS Executive Director Diane Oakley said. "For decades, large shares of Americans had access to a 'three-lane highway' to retirement security: a pension, Social Security and individual savings. This year, as the first of some 78 million Baby Boomers turn 65, they are experiencing a road to retirement that is shaky and full of potholes. The research indicates that the American people need and want relief from their retirement anxiety."

The report's findings were based on a phone survey of 800 individuals age 25 and older.

The NIRS conference and report received extensive – and largely positive – media coverage from outlets such as CNBC, *Forbes*, Reuters and *U.S. News & World Report*.

CALIFORNIA CONGRESSIONAL DELEGATION NEWS

House Committee Votes to Strip EPA of Greenhouse Gas Authority

A House panel on March 15 voted to strip the Environmental Protection Agency of the authority to regulate greenhouse gas emissions to stem climate change.

The Energy and Commerce Committee approved the "Energy Tax Prevention Act" (H.R. 910) from committee Chairman Fred Upton by a 34-19 vote, with three Democrats joining all of the Republican members of the panel. The legislation would amend the Clean Air Act to prohibit the EPA from regulating "the emission of a greenhouse gas to address climate change."

"This bill does not roll back the Clean Air Act in any way," said Rep. Ed Whitfield, R-Ky., chairman of the committee's Energy and Power Subcommittee. "Rather, this bill stops EPA from imposing far-reaching and costly regulations without regard for their impact on the economy and jobs. Any decision of this magnitude deserves consideration by elected members of Congress and must not be ceded to unelected executive branch staff. This bill will help to preserve jobs and protect our ability to remain competitive in a global economy."

Before the final vote, Republicans defeated three amendments proposed by Democrats that would have declared that "Congress accepts the scientific finding … that 'warming of the climate system is unequivocal'"; that the scientific evidence regarding climate change "is compelling"; and that "human-caused climate change is a threat to public health and welfare."

Rep. Henry Waxman, D-Calif., ranking member of the House Energy and Commerce Committee and sponsor of a 2009 bill that passed the House that would have created a cap-and-trade system for carbon emissions, sponsored one of the amendments, but said none of them should have been necessary because the "finding is so obviously correct." Rep. Joe Barton, R-Texas, however, said that the science of the issue was "not settled."

A vote on the bill by the full House is expected before Easter.

Senate Environment and Public Works Committee Ranking Member James Inhofe, R-Okla., has introduced a companion to Upton's measure. Also, Senate Minority Leader Mitch McConnell, R-Ky., attached language nearly identical to Upton's legislation to a small business bill being considered in that chamber.

"They're attempting to do through regulation what they couldn't do through legislation, regardless of whether the American people want it or not," McConnell said. "This is an insult to the millions of Americans who are already struggling to make ends meet or find a job."

The proposal has a good chance of passing the Republican-controlled House, but, even though it has the support of a handful of Democratic senators, it is unlikely to make it through the Democratically-controlled Senate. Obama has pledged to veto any such measure if it reaches his desk.